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C O N F I D E N T I A L SECTION 01 OF 03 CARACAS 002944

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TAGS: EPET EINV VE
SUBJECT: GOV HYDROCARBON POLICY OPTIONS

REF: A. CARACAS 02934

¶B. CARACAS 02596

Classified By: Economic Counselor Andrew Bowen for Reason 1.4 (D)

SUMMARY

¶1. (C) Reftel A outlined Embassy's views that declining production stemming from inadequate maintenance and a decline in PDVSA's administrative and operational abilities could have a significant impact on GOV revenues. It is not clear at what point declining production will start to squeeze the GOV fiscally. Once declines in production levels and/or declining prices begin to cause the GOV problems, we believe it will have four basic policy options: a broad rapprochement with the international oil companies (IOCs), a heavier reliance on major service companies to provide PDVSA with needed expertise, the acceptance of a minimal production level provided prices stay high and the GOV is willing to economize, or a strong arm policy to extract more revenues from the IOCs and service companies. The policy options are not necessarily exclusive. At this point, if we had to make a guess, we believe the GOV would combine aspects of both the first and fourth options: a limited rapprochement with strong arm tactics to secure more revenues. END SUMMARY

WHAT ARE THE GOV'S OPTIONS?

¶2. (C) Under the GOV's Siembra Petrolera plan, the GOV plans to increase daily production to 5.8 million barrels a day by ¶2012. As laid out in Reftel A, we believe the GOV will actually face declining production levels in the short to medium term. If the GOV is eventually faced with a decline in production that threatens its revenue stream, it will have four basic policy options: a broad rapprochement with the international oil companies (IOCs), a heavier reliance on major service companies to provide PDVSA with needed expertise, the acceptance of a minimal production level provided prices stay high, or a strong arm policy to extract more revenues from the IOCs. We do not believe that reliance on national oil companies (NOCs) is an option because the majority of them do not have the necessary technical expertise to handle Venezula's heavy and extra heavy crudes. At this point, we believe that the GOV will pursue a combination of the first and fourth options.

¶3. (C) We do not believe that the GOV will opt for the second or third options. Up to this point, we have not seen any action on the part of PDVSA to place greater reliance on the major service companies in order to compensate for its technical deficiencies. When we raised the possibility with Halliburton and Baker Hughes, neither of them thought it was a realistic possibility. In fact, executives from both companies believe the GOV will begin making life more difficult for them once it is through adjusting its relationships with the IOCs. Relying on the service companies for technical expertise is also out of the question for practical reasons. The service companies are capable of handling large scale projects but they do not offer the full scope of services that an IOC can offer. If PDVSA significantly increased its reliance on service companies, it would need a technically and commercially sophisticated staff to handle the influx of new tenders and contracts. As noted in Reftel A, PDVSA simply does not have the administrative resources to carry out such a program.

¶4. (C) We also do not believe the GOV will accept a minimal production level provided prices stay high for two reasons. First, it is not clear at what point PDVSA's production level will bottom out. The point may well be below the necessary level to fund the GOV's current spending spree as well as meet its Petroamerica commitments. Second, even if you assume production does bottom out at the necessary level, the GOV continues to increase its spending and shows no signs of slowing down. As a result, we believe it will need additional oil revenues as well as increased tax revenues.

¶5. (C) It is clear from coversatons tht we havehad wih he IOC thatthey believe the GOV will eventually have to have some sort of broad rapprochement with them in order to increase production. (Note: As noted in Reftel A, IOCs account for roughly 45 percent of Venezuela's oil production. End Note) Based on history, this is not an unreasonable position. Countries have traditionally opened their oil sectors to foreign investment when they have reached a point where they can no longer develop their resources on their own. As former PDVSA director and noted commentator Jose Toro pointed out in a lunch with PetAtt, Venezuela's famous apertura did not come about due to a philosophical change within the GOV. It occurred because the GOV realized that it did not have the necessary capital or expertise to develop the sector on its own. The problem with this line of reasoning is that it assumes the GOV is a rational economic actor and that President Chavez will sacrifice his political goals for economic expediency. We are not sure that either of these underlying assumptions is correct.

¶6. (C) We believe the GOV will favor one or more IOCs and a handful of NOCs from select friendly countries while at the same time seeking to extract as much revenue as possible from the rest of the IOCs and NOCs. The "teacher's pets" may be subject to the same harsh tax policies and pressure to convert operating service agreements (OSAs) to joint ventures as the rest of the IOCs and NOCs but will be rewarded with choice projects. We are not alone in this viewpoint. Chevron Latin America Upstream President Ali Moshiri stated he believes one or two American oil companies will continue to be significant players in Venezuela as well as six NOCs. These companies will receive the lions share of new projects, including the all important Faja projects. Assuming two American companies remain active participants in Venezuela, Moshiri said one of the American companies will have the lead and the other will merely be a partner. It was clear Moshiri believes he is positioning Chevron to be the lead American company. (COMMENT: Chevron, ConocoPhilips, and ExxonMobil currently operate in Venezuela. We believe the American "partner" will be ConocoPhilips. ExxonMobil has taken a hard line with the GOV regarding royalty payments and is currently considering international arbitration. President Chavez, as reported in Reftel B, publicly took a swipe at ExxonMobil in his speech announcing the Siembra Petrolera development plan. END COMMENT)

¶7. (C) It is not clear if Moshiri believes the other IOCs and NOCs will simply be frozen at their current level of activities or eventually pushed out. We believe the companies will be allowed to continue their current level of operations but the GOV will squeeze them as much as possible for additional revenue. However, it is possible one or more of the IOCs and NOCs will be forced out of Venezuela. On September 26, Energy Minister Ramirez publicly threatened to take over fields operated by oil companies under OSAs if they did not migrate the contracts to joint venture companies controlled by PDVSA by the end of the year. Given the legal complexities of migrating the contracts, we do not believe nor have we found a single energy attorney or IOC executive who believes that it is possible to migrate the contracts in such a limited period of time.

¶8. (C) At this point, it is our belief that the GOV may make examples out of one or two companies but it will seek to avoid taking over all or a majority of the fields. We base this belief on two facts. First, as noted in Reftel A, PDVSA does not have enough qualified staff to run 32 "new" oil fields. Second, a successful migration from an OSA to a joint venture company under PDVSA control will allow the GOV to reach its goals of maximizing state oil revenues and control of reserves with a minimum outlay of resources. Once the OSAs and strategic associations have migrated to joint ventures under PDVSA control, the GOV will be in the perfect position to exert pressure on the foreign companies to maximize its revenues. If the GOV has a 60 percent interest in the new joint ventures, which Ramirez stated on September 26 was the new minimum, it can basically strong arm its minority partners whenever it likes while at the same time benefiting from IOC and NOC operating expertise. The trick will be for the GOV to exert just enough pressure to maximize revenues without exerting so much that the foreign companies halt production.

¶9. (C) Toro, who is no fan of Chevron, also believes the GOV wants to have at least one major American IOC that is active in Venezuela. He believes the GOV wants to utilize the company to lobby Congress and act as a mode of communication with key USG departments and agencies. Toro indicated he believes Chevron will be the GOV's American company of choice. When pressed about NOCs, Toro said he thought Russian and Chinese companies would be the main beneficiaries. He said Petrobras was still a contender for preferential treatment but that depended to a large extent on whether the current Brazilian government stays in power or is replaced by one that meets with President Chavez's approval.

CONCLUSION

¶10. (C) We believe the next three months will provide valuable clues as to where the GOV's hydrocarbon policy is headed. Oil companies with OSAs will be receiving their tax bills in the next two to three weeks. It will be interesting to see whether any of the "teacher's pets" receive preferential treatment. In addition, the GOV has stated repeatedly that OSAs must migrate to joint venture companies by year end. Ramirez's comments on September 26 were clearly designed to raise the temperature on the oil companies with OSAs. Since the migration of 32 unique contracts by years end is impossible, the GOV's actions once its deadline is not met will provide clues on where it is headed next.
Brownfield